fulfilled if customers continue to use general-purpose servers. The role of our products could, for example, be limited if general-purpose servers become better at performing functions currently being performed by server appliances or are offered at a lower cost. This could force us to further lower the prices of our products or result in fewer sales of our products, which would negatively impact our revenues or force us to lower the prices of our server appliance solutions, which would decrease our gross profits.

The products that we sell are subject to rapid technological change and our sales will suffer if these products are rendered obsolete by new technologies.

The markets we serve are characterized by rapid technological change, frequent new product introductions and enhancements, potentially short product life cycles, changes in customer demands and evolving industry standards. In the server appliance market, we attempt to mitigate these risks by utilizing standards-based hardware platforms and by maintaining an adequate knowledge base of available technologies. However, the server appliance products that we sell could be rendered obsolete if products based on new technologies are introduced or new industry standards emerge and we are not able to incorporate these technological changes into our products. Likewise, if data storage vendors develop products that incorporate the functionality of the Fibre Channel HBAs that we distribute, the marketability of the Fibre Channel HBAs that we distribute will suffer and our distribution sales will be materially adversely affected. Further, we do not have extensive experience in the network security market and if we are unable to provide the appropriate products for the network security market, our anticipated distribution sales will suffer. To remain competitive in the server appliance market, we must successfully identify new product opportunities and develop and bring new products to market in a timely and cost-effective manner. To maintain the competitiveness of our Distribution business, we must continue to provide products and services that our customers require and continue to identify new products and services that meet the changing needs of our current and prospective customers. Our failure to keep pace with rapid industry, technological or market changes could have a material adverse effect on our business, results of operations or financial condition.

The cyclical nature of the data storage industry could hurt our operating results.

The data storage industry has historically been characterized by fluctuations in product demand and supply, and, consequently, severe fluctuations in price. In recent years, this industry has experienced a significant downturn in demand resulting in excess production levels, and we are uncertain as to the severity and duration of future demand downturns, if any. Although our distribution agreements with some manufacturers provide us with limited price protection and limited rights of return, any shortfalls in demand and excess production could hurt our distribution sales and gross profits. If any such shortfalls in demand or such excess production were to continue for a prolonged period of time, our results of operations would be materially adversely affected. In addition, many of our VAR and system integrator customers in the data storage industry are subject to the risks of significant shifts in demand and severe price pressures by their customers, which may increase the risk that we may not be able to collect accounts receivable owed by some of our customers. If we are unable to collect accounts receivable, our results of operations and financial condition may suffer. We cannot assure you of the timing, duration or magnitude of any

recovery in the markets in which we operate, or that such markets will not experience renewed, and possibly more severe and prolonged downturns in the future, or that our operating results or financial condition will not be adversely affected by them.

Conversely, if the data storage industry experiences significant unit volume growth that, in turn, results in increased demand for any of the products we distribute, we may experience a shortage of our products. In such event, our operating results could depend on the amount of product allocated to us by manufacturers and the timely receipt of such product.

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Risks related to competition.

Competition in our markets is intense and if we fail to compete effectively our financial results will suffer.

In the server appliance market, we face significant competition from a number of different types of companies. Our competitors include companies who market general-purpose servers, specific-purpose servers and server appliances as well as companies that sell custom integration services utilizing hardware produced by other companies. Many of these companies are larger than we are and have greater financial resources and name recognition than we do, as well as significant distribution capabilities and larger, more established service organizations to support their products. Our large competitors may be able to leverage their existing resources, including their extensive distribution capabilities and their service organizations, to provide a wider offering of products and services and higher levels of support on a more cost-effective basis than we can. We expect competition in the appliance market to increase significantly as more companies enter the market and as our existing competitors continue to improve the performance of their current products and to introduce new products and technologies. Such increased competition could adversely affect sales of our current and future products and services. In addition, competing companies may be able to undertake more extensive promotional activities, adopt more aggressive pricing policies and offer more attractive terms to their customers than we can. If our competitors provide lower cost products with greater functionality or support than our server appliance solutions, or if some of their products are comparable to ours and are offered as part of a range of products that is broader than ours, our server appliance solutions could become undesirable. Even if the functionality of competing products is equivalent to ours, we face a risk that a significant number of customers would elect to pay a premium for similar functionality rather than purchase products from a less-established vendor. We attempt to differentiate ourselves from our competition by offering a wide variety of software integration, branding, supply-chain management, engineering, support, distribution, logistics and fulfillment services. If we are unable to effectively differentiate our products and services from those of our competition, our revenues will not increase and may decline. Furthermore, increased competition could negatively affect our business and future operating results by leading to price reductions, higher selling expenses and a reduction in our market share.

Likewise, the data storage and network security industries are highly competitive. As a result of our acquisition of TidalWire, we now compete against a variety of companies, such as other commercial distributors of data storage products. As we enter the network security market, the number of companies that

we compete with will further increase. Some of our current and future competitors have significantly greater financial, technical, marketing, distribution and other resources than we do and may be able to respond more quickly than us to new or emerging technologies and changes in customer requirements, which could reduce our market share. These competitors may also establish or strengthen cooperative relationships with our key customers and other parties with whom we have strategic relationships, which could harm our ability to distribute our current and future products.

Our revenues could be negatively affected if our larger competitors consolidate their extensive distribution capabilities with our smaller competitors' products.

Large server manufacturers may not only develop their own server appliance solutions, but they may also acquire or establish cooperative relationships with our smaller competitors, developing server

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appliance products and related technologies. Because large server manufacturers have significant financial and organizational resources available, they may be able to quickly penetrate the server appliance market by leveraging the technology and expertise of smaller companies with their own extensive distribution channels. We expect that the server industry will experience further consolidation. It is possible that new competitors or alliances among competitors may emerge and rapidly acquire significant market share through consolidation. Consolidation within the server marketplace could adversely affect our revenues.

Risks related to marketing and sales efforts.

We need to effectively manage our sales and marketing operations to increase market awareness and sales of our products and services and to promote our brand recognition. If we fail to do so, our growth will be limited.

Although we have a relatively small sales and marketing organization, we must continue to increase market awareness and sales of our products and services and promote our brand in the marketplace. In the rapidly evolving market for server appliance solutions, we believe that to compete successfully we will need network equipment providers and ISVs to recognize Network Engines as a top-tier provider of server appliance platforms, custom integration services and server appliance distribution services. In the market for data storage and network security products, we will need VARs and systems integrators to recognize TidalWire as a leading value-added distributor of these products. If we are unable to design and implement effective marketing campaigns or otherwise fail to promote and maintain the Network Engines and TidalWire brands, we may not increase or maintain sales and our business may be adversely affected. Our business would also suffer if we incur excessive expenses promoting and maintaining these brands but fail to achieve the expected or desired increase in revenues.

If we are unable to effectively manage our customer service and support activities, we may not be able to retain our existing customers and attract new customers.

We need to effectively manage our customer support operations to ensure that we

maintain good relationships with our customers. We outsource certain of our customer support activities to a third party and, therefore, we depend on this third party to successfully address our customers' needs. If this customer support organization is unsuccessful in maintaining good customer relationships, we may lose customers to our competitors and our reputation in the market could be damaged. As a result, we may lose revenue and incur losses greater than expected.

Risks related to product manufacturing.

Our dependence on sole source and limited source suppliers for key components makes us susceptible to supply shortages and potential quality issues that could prevent us from shipping customer orders on time, if at all, and could result in lost sales and customers.

We depend upon single source and limited source suppliers for our industry-standard processors, main logic boards, certain disk drives, hardware platforms and power supplies as well as our cooling systems, chassis and sheet metal parts. We also depend on limited sources to supply several other industry-standard components. We have in the past experienced, and may in the future experience,

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shortages of or difficulties in acquiring components in the quantities and of the quality needed to produce our products. Shortages in supply of these key components for an extended time would cause delays in the production of our products, prevent us from satisfying our contractual obligations and meeting customer expectations, and result in lost sales and customers. If we are unable to buy components in the quantities and of the quality that we need on a timely basis or at acceptable prices, we will not be able to manufacture and deliver our products on a timely or cost-effective basis to our customers, and our competitive position, reputation, business, financial condition and results of operations could be seriously harmed.

If our server appliance solutions fail to perform properly and conform to specifications, our customers may demand refunds, assert claims for damages or terminate existing relationships with us and our reputation and operating results may materially suffer.

Because our server appliance hardware platforms are complex, they could contain errors that can be detected at any point in a product's life cycle. In addition, because our solutions are combined with products from other vendors, should problems occur, it might be difficult to identify the source of the problem. In the past, we have discovered errors in some of our server appliance solutions and have experienced delays in the shipment of our server appliance products during the period required to correct these errors or we have had to replace defective products that were already shipped. For example, in our last fiscal year, we incurred substantially higher than anticipated warranty charges as the result of defects discovered in one of the third party components previously used in some of our server appliance solutions. Errors in our server appliance solutions may be found in the future and any of these errors could be significant. Significant errors, including those discussed above, may result in:

Ythe loss of or delay in market acceptance and sales of our server appliance products;

Ydiversion of engineering resources;

Ythe loss of new or existing server appliance partners;

Yinjury to our reputation and other customer relations problems; and

Yincreased maintenance and warranty costs.

Any of these problems could harm our business and future operating results. Product errors or delays could be material, including any product errors or delays associated with the introduction of new products or versions of existing products. If our server appliance solutions fail to conform to warranted specifications, customers could demand a refund for the purchase price and assert claims for damages.

Moreover, because our server appliance solutions may be used in connection with critical computing systems services, we may receive significant liability claims if they do not work properly. While our agreements with customers typically contain provisions intended to limit our exposure to liability claims, these limitations do not preclude all potential claims. Liability claims could exceed our insurance coverage and require us to spend significant time and money in litigation or to pay significant damages. Any claims for damages, even if unsuccessful, could seriously damage our reputation and business.

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Our future server appliance revenue growth is dependent on our ability to expand production capacity.

Our existing manufacturing facility is limited in its production capacity. For us to achieve significant server appliance revenue growth our server appliance sales volumes must increase significantly and our production capacity must increase to support such sales volumes. To supplement our production capacity, we utilize the services of a contract manufacturer. However, our contract manufacturer is not obligated to supply products to us for any specific period, or in any specific quantity, except as may be provided in a particular purchase order. Using a contract manufacturer increases our cost of producing products and could decrease our gross profits. In the event that we need to change contract manufacturers or require significantly increased production levels, we could experience transitional difficulties, including production delays and quality control issues, that could prevent us from satisfying our production requirements on a timely basis, cause customer relationships to suffer and result in lost sales. Also, the use of a contract manufacturer does not guarantee us production levels, manufacturing line space or manufacturing prices, the lack of which could interrupt our business operations and have a negative effect on operating results.

If we do not accurately forecast our component and product requirements, our business and operating results could be adversely affected.

We use rolling forecasts based on anticipated product orders to determine our

component requirements. Lead times for materials and components that we order vary significantly, among other things, on factors including specific supplier requirements, contract terms and current market demand for those components. In addition, a variety of factors, including the timing of product releases, potential delays or cancellations of orders and the timing of large orders, make it difficult to predict product orders. As a result, our component and product requirement forecasts may not be accurate. If we overestimate our component and product requirements, we may have excess inventory, which would increase costs and negatively impact our cash position. If we underestimate our component and product requirements, we may have inadequate inventory, which could interrupt our manufacturing and delay delivery of our products to customers resulting in a loss of sales or customers. Any of these occurrences would negatively impact our business and operating results.

Our Distribution business is dependent on certain suppliers and our business would suffer if we lost any significant suppliers or faced a product shortage.

Our Distribution business is highly dependent on suppliers for substantially all of the products that we sell. A small number of data storage suppliers provide products that represent a significant majority of our storage distribution sales. The loss of any significant supplier could harm our financial condition and results of operations. Our distribution agreements are cancelable on short notice. Our reliance on a small number of suppliers for our Distribution business leaves us vulnerable to having an inadequate supply of required products, price increases, late deliveries and poor product quality. From time to time, our Distribution business, like other distributors in this industry, has experienced supply shortages and we have been unable to purchase our desired volume of products. If we are unable to enter into and maintain satisfactory distribution arrangements with leading suppliers and an adequate supply of products, our revenues could suffer considerably.

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Risks related to product dependence on intellectual property.

Our reliance upon contractual provisions, domestic patent, copyright and trademark laws and applied-for patents to protect our proprietary rights may not be sufficient to protect our intellectual property.

Certain of our server appliance solutions are differentiated from the products of our competitors by our internally developed software and hardware and the manner in which they are integrated into our server appliance solutions. If we fail to protect our intellectual property, other vendors could sell products with features similar to ours, which could reduce demand for our solutions. We believe that the steps we have taken to safeguard our intellectual property afford only limited protection. Others may develop technologies that are similar or superior to our technology or design around the copyrights and trade secrets we own. Despite the precautions we have taken, laws and contractual restrictions may not be sufficient to prevent misappropriation of our technology or deter others from developing similar technologies. In addition, there can be no guarantee that any of our patent applications will result in patents, or that any such patents would provide effective protection of our technology.

In addition, the laws of the countries in which we may decide to market our services and solutions may offer little or no effective protection of our proprietary technology. Reverse engineering, unauthorized copying or other

misappropriation of our proprietary technology could enable third parties to benefit from our technology without paying us for it, which would significantly harm our business.

Our operating results would suffer if we were subject to a protracted infringement claim or one that resulted in a significant damages award.

Substantial litigation regarding intellectual property rights exists in the technology industry. We expect that server appliance products may be subject to third-party infringement claims as the number of competitors in the industry segment grows and the functionality of products in different industry segments overlaps. From time to time we receive claims from third parties that our server appliance products have infringed their intellectual property rights. Although we do not believe that our server appliance products employ technology that infringes the proprietary rights of any third parties, third parties may make claims that, with or without merit, could:

Ybe time-consuming to defend;

Yresult in costly litigation, including potential liability for damages;

Ydivert our management's attention and resources;

Ycause product shipment delays; and

Yrequire us to enter into royalty or licensing agreements.

Royalty or licensing agreements may not be available on terms acceptable to us, if at all. A successful claim of product infringement against us or the failure or inability to license the infringed or similar technology could adversely affect our business because we would not be able to sell the impacted product without redeveloping it or incurring significant additional expenses.

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Other risks related to our business.

If the site of our manufacturing operations, third-party distribution center or third-party post-sales support provider were to experience a significant disruption in its operations, it would have a material adverse effect on our financial condition and results of our operations.

Our manufacturing facility and headquarters are concentrated in one location. In addition, our third-party distribution center in Memphis, Tennessee handles substantially all of the distribution of the products of our Distribution business and our third-party post-sales support center in Westborough, Massachusetts handles substantially all of the post-sales support obligations for our Distribution business. If the operations of any of these facilities were disrupted as a result of a natural disaster, fire, power or other utility outage, work stoppage or other similar event, our business could be seriously harmed as a result of interruptions or delays in our manufacturing or

Distribution operations.

Class action lawsuits have been filed against us, our board of directors, our chairman and certain of our executive officers and other lawsuits may be instituted against us from time to time.

In December 2001, a class action lawsuit relating to our initial public offering was filed against us, our chairman, one of our executive officers and the underwriters of our initial public offering. In addition, in January 2003, a purported class action lawsuit was filed against us and our Board of Directors relating to the acquisition of TidalWire Inc. More recently, on December 16, 2003, a purported class action lawsuit was filed against us and John H. Curtis, our President and CEO, Douglas G. Bryant, our CFO, Vice President of Finance and Administration, Treasurer and Secretary, and Lawrence Genovesi, our Chairman of the Board and former President relating to the timing of our announcement of the amendment of our HBA distribution agreement with EMC. For more information on these lawsuits, see "Business - Legal Proceedings." In December 2003, we settled the class action lawsuit filed against us relating to the acquisition of TidalWire Inc. and we are currently attempting to settle the lawsuit filed against us related to our initial public offering. We are unable to predict the effects on our financial condition, or our business, of the lawsuit related to our initial public offering, the lawsuit related to our announcement of the amendment of our HBA distribution agreement with EMC or other lawsuits that may arise from time to time. While we maintain certain insurance coverage, there can be no assurance that claims against us will not result in substantial monetary damages in excess of such insurance coverage. In addition, we have and may in the future expend significant resources to defend such claims. These class action lawsuits, or other similar lawsuits that may arise from time to time, could negatively impact both our financial condition and the market price of our common stock.

If we fail to retain and attract appropriate levels of qualified technical personnel, we may not be able to develop and introduce our products on a timely basis.

We require the services of qualified technical personnel. In the past, we have experienced the negative effects of an economic slowdown, including significant declines in our revenues and a significant decrease in the market price of our common stock. As a result, we have implemented various personnel reductions, which placed added pressure on our remaining employees. These and other factors may make it difficult for us to retain and attract the qualified employees that we need to effectively manage our business operations, including key engineering activities. If we are unable to

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retain and attract a sufficient number of technical personnel we may not be able to complete development of, or upgrade or enhance, our products in a timely manner, or successfully integrate our network equipment and ISV partners' software with our hardware platforms, any of which could negatively impact our business and could hinder any future growth.

If we do not retain our senior management, we may not be able to successfully execute our business strategy.

Since our restructurings in fiscal 2001 and 2002, and as a result of our

acquisition of TidalWire, we have added key members to our current management team. The loss of key members of our management team could harm us. Our success is substantially dependent on the ability, experience and performance of our senior management team. Because of their ability and experience, we may not be able to successfully execute our business strategy if we were to lose one or more of these individuals. If we are unable to successfully execute our business strategy, our operating results would suffer.

The market price for our common stock may be particularly volatile, and our stockholders may be unable to resell their shares at a profit.

The market price of our common stock has been subject to significant fluctuations and may continue to fluctuate or decline. During fiscal 2003, the price of our common stock ranged from a low of $0.92 to a high of $7.51. The stock markets have experienced significant price and trading volume fluctuations. The market for technology stocks has been extremely volatile and frequently reaches levels that bear no relationship to the past or present operating performance of those companies. General economic conditions, such as recession or interest rate or currency rate fluctuations in the United States or abroad, could negatively affect the market price of our common stock. In addition, our operating results may be below the expectations of securities analysts and investors. If this were to occur, the market price of our common stock would likely significantly decrease. In the past, following periods of volatility in the market price of a company's securities, securities class action litigation has often been instituted against such companies. Such litigation could result in substantial cost and a diversion of management's attention and resources.

The market price of our common stock may fluctuate in response to various factors, some of which are beyond our control. These factors include, but are not limited to, the following:

Ychanges in market valuations or earnings of our competitors or other technology companies;

Yactual or anticipated fluctuations in our operating results;

Ychanges in financial estimates or investment recommendations by securities analysts who follow our business;

Ytechnological advances or introduction of new products by us or our competitors;

Ythe loss of key personnel;

Your sale of common stock or other securities in the future;

Ysignificant sales of our common stock by existing stockholders, affiliates and insiders;

Yintellectual property or litigation developments;

Ychanges in business or regulatory conditions;

Ythe trading volume of our common stock; and

Ydisruptions in the geopolitical environment, including war in the Middle East or elsewhere or acts of terrorism in the United States or elsewhere.

The decline in the market price of our common stock and market conditions generally could adversely affect our ability to raise additional capital, to complete future acquisitions of or investments in other businesses and to attract and retain qualified technical and sales and marketing personnel.

We have anti-takeover defenses that could delay or prevent an acquisition and could adversely affect the price of our common stock.

Our Board of Directors has the authority to issue up to 5,000,000 shares of preferred stock and, without any further vote or action on the part of the stockholders, will have the authority to determine the price, rights, preferences, privileges and restrictions of the preferred stock. This preferred stock, if issued, might have preference over the rights of the holders of common stock and could adversely affect the price of our common stock. The issuance of this preferred stock may make it more difficult for a third party to acquire us or to acquire a majority of our outstanding voting stock. We currently have no plans to issue preferred stock.

In addition, provisions of our second amended and restated certificate of incorporation, second amended and restated by-laws may deter an unsolicited offer to purchase us. These provisions, coupled with the provisions of the Delaware General Corporation Law, may delay or impede a merger, tender offer or proxy contest involving us. For example, our Board of Directors is divided into three classes, only one of which is elected at each annual meeting. These factors may further delay or prevent a change of control of our business.

ITEM 7A. QUANTITATIVEAND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We do not engage in any foreign currency hedging transactions and therefore, do not believe we are subject to exchange rate risk. We are exposed to market risk related to changes in interest rates. We invest excess cash balances in cash equivalents. We believe that the effect, if any, of reasonably possible near-term changes in interest rates on our financial position, results of operations and cash flows will not be material.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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REPORT OF INDEPENDENT AUDITORS

Tothe Board of Directors and Stockholders

ofNetwork Engines, Inc.:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, of stockholders' equity and of cash flows present fairly, in all material respects, the financial position of Network Engines, Inc. and its subsidiaries at September 30, 2003 and 2002, and the results of their operations and their cash flows for each of the three years in the period ended September 30, 2003 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

/s/ P
RICEWATERHOUSE
C
OOPERS
LLP

Boston, Massachusetts

November 5, 2003, except for Note 16
as to which the date is December 18, 2003

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NETWORK ENGINES, INC.

CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share data)

	September 30,	
	2002	2003
ASSETS		
Current assets:		
Cash and cash equivalents	$ 46,552	$ 36,788
Short-term investments	8,546	--
Restricted cash	1,098	47
Accounts receivable, net of allowances of $349 and $634 at September 30, 2002 and 2003, respectively	2,729	13,948
Inventories	1,956	14,937
Prepaid expenses and other current assets	1,065	1,946
Total current assets	61,946	67,666
Property and equipment, net	2,236	1,849
Goodwill	--	7,786
Intangible assets, net	--	4,310
Other assets	28	121
Total assets	$ 64,210	$ 81,732

LIABILITIES AND STOCKHOLDERS' E

QUITY

Current liabilities:		
Accounts payable	$ 1,474	$ 13,864
Accrued compensation and other related benefits	683	1,365
Other accrued expenses	785	1,398
Short-term portion of accrued restructuring and other charges	355	218
Deferred revenue	23	603
Current portion of capital lease obligations and notes payable	14	--
Total current liabilities	3,334	17,448
Long-term portion of accrued restructuring and other charges		60
Commitments and contingencies (Note 11)		
Stockholders' equity:		
Preferred stock, $.01 par value, 5,000,000 authorized, and no shares issued and outstanding	--	--
Common stock, $.01 par value, 100,000,000 shares authorized; 35,679,075 and 38,183,158 shares issued; 30,780,972 and 35,621,300 shares outstanding at September 30, 2002 and 2003, respectively	357	382
Additional paid-in capital	174,252	176,061
Accumulated deficit	(107,563)	(108,948)
Notes receivable from stockholders	(281)	--
Deferred stock compensation	(1,185)	(433)
Treasury stock, at cost, 4,898,103 and 2,561,858 shares at September 30, 2002 and 2003, respectively	(4,707)	(2,838)
Accumulated other comprehensive income	3	--
Total stockholders' equity	60,876	64,224
Total liabilities and stockholders' equity	$ 64,210	$ 81,732

The accompanying notes are an integral part of the consolidated financial statements.

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NETWORK ENGINES, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

	Year ended September 30,		
	2001	2002	2003
Net revenues	$ 13,515	$ 14,534	$81,243
Cost of revenues:			
Cost of revenues	12,349	12,329	64,450
Cost of revenues from stock compensation	332	147	56
Inventory write-down	20,278	--	--
Total cost of revenues	32,959	12,476	64,506
Gross profit (loss)	(19,444)	2,058	16,737
Operating expenses:			
Research and development (excluding stock compensation of $3,392, $3,542 and $46 for the years ended September 30, 2001, 2002 and 2003, respectively)	12,704	4,693	4,114
Selling and marketing (excluding stock compensation of $1,244, $65 and $151 for the years ended September 30, 2001, 2002 and 2003, respectively)	18,118	3,836	6,519
General and administrative (excluding stock compensation of $1,164, $684 and $731 for the years ended September 30, 2001, 2002 and 2003, respectively)	7,047	4,602	5,856
Stock compensation	5,800	4,291	928
Restructuring and other charges	10,886	353	507
Amortization of intangible assets	675	--	762
Total operating expenses	55,230	17,775	18,686
Loss from operations	(74,674)	(15,717)	(1,949)
Interest income	5,175	1,596	573
Interest expense and other	(24)	(4)	(9)

Net loss	(69,523)	(14,125)	(1,385)
Net loss per share--basic and diluted	$ (2.03)	$ (0.44)	$ (0.04)
Shares used in computing basic and diluted net loss per share	34,241	32,270	33,142

The accompanying notes are an integral part of the consolidated financial statements.

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NETWORK ENGINES, INC.

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

(in thousands, except share data)

	Shares of Common Stock Issued	Shares of Common Stock In Treasury	Common Stock Par value	Additional Paid-in Capital	Accumulated Deficit	Notes Receivable from Stockholders	Deferred Stock Compensation	Treasury Stock	Accumulated Other Comprehensive Income	Total Stockholders' Equity	Comprehensive Loss
Balance, September 30, 2000	34,218,585	--	$ 342	$ 171,314	$ (23,915)	$ (94)	$ (12,171)	--	$ --	$ 135,476	
Issuance of common stock upon stock option exercises	243,624		2	59						61	
Issuance of common stock upon warrant exercises	159,065		2	23						25	
Issuance of common stock under employee stock purchase plan	116,372		1	396						397	
Acquisition of IP											

Performance, Inc.	450,449		5	8,887			(6,351)			2,541	
Purchase of treasury stock		(300,900)						(198)		(198)	
Issuance of stockholder notes receivable						(584)				(584)	
Interest on notes receivable from stockholders						(24)				(24)	
Amortization of deferred stock compensation to expense							6,132			6,132	
Stock compensation related to common stock option modifications				186						186	
Reversal of deferred compensation related to cancellation of stock options				(5,577)			5,577			--	
Net loss					(69,523)					(69,523)$	(69,523)
Balance, September 30, 2001	35,188,095	(300,900)	352	175,288	(93,438)	(702)	(6,813)	(198)	--	74,489	
Issuance of common stock upon cash stock option exercises	294,830		3	65						68	
Issuance of common stock upon cashless stock option exercises	119,469	(23,159)	1	23				(24)		--	
Issuance of common stock											

under employee stock purchase plan	76,681		1	66						67	
Purchase of treasury stock		(4,097,592)						(4,074)		(4,074)	
										--	
Cash collection of stockholder notes receivable						45				45	
Collection of stockholder notes receivable in exchange for common stock		(476,452)				411		(411)		--	
Interest on notes receivable from stockholders						(35)				(35)	
Amortization of deferred stock compensation to expense							4,438			4,438	
Reversal of deferred compensation related to cancellation of stock options				(1,190)			1,190			--	
Unrealized gain on short-term investments									3	3	$ 3
Net loss					(14,125)					(14,125)	(14,125)

										--	$ (14,122)
	-------------------	---------------	----------	-----------	-----------	-----------	--------	------------	------------	------------	------------
Balance, September 30, 2002	35,679,075	(4,898,103)	357	174,252	(107,563)	(281)	(1,185)	(4,707)	3	60,876	

The accompanying notes are an integral part of the consolidated financial statements.

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NETWORK ENGINES, INC.

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (DEFICIT)--(Continued)

(in thousands, except share data)

	Shares of Common Stock Issued	Shares of Common Stock In Treasury	Common Stock Par value	Additional Paid-in Capital	Accumulated Deficit	Notes Receivable from Stockholders	Deferred Stock Compensation	Treasury Stock	Accumulated other Comprehensive Income	Total Stockholders' Equity	Comprehensive Loss
Balance, September 30, 2002	35,679,075	(4,898,103)	357	174,252	(107,563)	(281)	(1,185)	(4,707)	3	60,876	
Issuance of common stock upon stock option exercises	1,345,756		13	747						760	
Issuance of common stock under employee stock purchase plan	169,876		2	141						143	
Issuance of common stock upon cashless warrant exercises	988,451		10	(10)						--	
Purchase of treasury stock		(308,000)						(312)		(312)	
Cash collection of stockholder notes receivable						4				4	
Conversion of restricted											

cash into amounts outstanding under guarantee agreement			(969)			(969)
Collection of amounts outstanding under guarantee agreement			456			456
Collection of stockholder notes receivable and amounts outstanding under guarantee agreement in exchange for common stock	(686,798)		1,031		(1,031)	--
Interest on notes receivable from stockholders			(13)			(13)
Reversal of reserve against notes receivable from stockholders			(228)			(228)
Acquisition of TidalWire Inc.	3,331,043	1,003		(304)	3,212	3,911
Amortization of deferred stock compensation to expense				984		984
Reversal of deferred compensation related to cancellation of stock options for		(72)		72		--

Realized gain on short-term investments									(3)	(3)$	(3)
Net loss					(1,385)					(1,385)	(1,385)
											$ (1,388)
Balance, September 30, 2003	38,183,158	(2,561,858)$	382$	176,061	$ (108,948)$	-- $	(433)$	(2,838)$	-- $	64,224	

The accompanying notes are an integral part of the consolidated financial statements.

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NETWORK ENGINES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Year Ended September 30,		
	2001	2002	2003
Cash flows from operating activities:			
Net loss	$(69,523)	$(14,125)	$ (1,385)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	3,722	1,536	2,379
Provision for doubtful accounts	755	29	166
Reversal of reserve for stockholder notes receivable	--	--	(228)
Provision for uncollectible sub-tenant receivables	--	--	138
Stock compensation	6,132	4,438	984
Interest on notes receivable from stockholders	(24)	(35)	(13)
Accrued income on short-term investments	--	(43)	--
Non-cash portion of restructuring and other charges	7,088	--	--
Changes in operating assets and liabilities, net of effects of acquisitions:			

Accounts receivable	9,449	(1,157)	(5,325)
Inventories	5,993	(1,349)	(10,117)
Prepaid expenses and other current assets	(923)	(208)	(778)
Due from contract manufacturer	6,733	380	--
Accounts payable	(5,831)	195	8,103
Due to contract manufacturer	3,117	(3,117)	--
Accrued expenses	1,101	(2,134)	178
Deferred revenue	(734)	(70)	548
	--------	--------	--------
Net cash used in operating activities	(32,945)	(15,660)	(5,350)
Cash flows from investing activities:			
Purchases of property and equipment	(3,102)	(318)	(782)
Purchases of short-term investments	--	(8,500)	--
Sales of short-term investments	--	--	8,546
Restrictions of cash	(1,082)	--	--
Refunds and repayments of restricted cash	--	31	83
Changes in other assets	(35)	143	(64)
Acquisitions, net of cash acquired	(30)	--	(11,101)
Payments of transaction costs	--	--	(2,133)
	--------	--------	--------
Net cash used in investing activities	(4,249)	(8,644)	(5,451)
Cash flows from financing activities:			
Payments on capital lease obligations and notes payable	(84)	(55)	(14)
Issuance of notes to stockholders	(584)	--	--
Collection of notes receivable from stockholders and collections under guarantee agreement	--	45	460
Proceeds from issuance of common stock	483	135	903
Acquisition of treasury stock	(198)	(4,074)	(312)
	--------	--------	--------
Net cash provided by (used in) financing activities	(383)	(3,949)	1,037
	--------	--------	--------

Net decrease in cash and cash equivalents	(37,577)	(28,253)	(9,764)
Cash and cash equivalents, beginning of year	112,382	74,805	46,552
Cash and cash equivalents, end of year	$ 74,805	$ 46,552	$ 36,788

Supplemental cash flow information:

Non-cash transactions:

Repurchase of common stock through cancellation of notes receivable from stockholders	$ --	$ 411	$ 1,031
Issuance of common stock in connection with cashless stock option exercises	$ --	$ 24	$ --
Conversion of restricted cash into amounts owed by stockholder under guarantee agreement	$ --	$ --	$ 969
Repurchase of common stock in exchange for amounts owed by stockholder under guarantee agreement	$ --	$ --	$ 518
Issuance of common stock upon cashless stock warrant exercises	$ 38	$ --	$ 346

The accompanying notes are an integral part of the consolidated financial statements.

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NETWORK ENGINES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. NATURE OF BUSINESS

Network Engines, Inc. ("Network Engines" or the "Company") develops, manufactures and distributes server appliances that enable network equipment providers and independent software vendors ("ISVs") to deliver data storage and security networking applications to their customers. The Company is focused on providing its strategic partners with server appliance hardware, integration services and appliance development, manufacturing, fulfillment, distribution and post-sale support to allow these strategic partners to deliver "turn-key" solutions to their end-user customers. The server appliance is sold and supported either by the Company's ISV partners or alternatively by the Company through its Distribution operation. Server appliances are pre-configured computer network infrastructure devices designed to deliver specific application functionality. In December 2002, the Company acquired TidalWire Inc. (see Note 3) and, as a result, also distributes third-party data storage networking connectivity products for Fibre Channel host bus adapter ("HBA") and storage switch manufacturers in the data storage industry to a channel of value added resellers ("VARs") and systems integrators. To date, the Company's customers have been primarily located in North America. The Company operates in two reportable segments: OEM Appliance and Distribution.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany transactions and balances have been eliminated. Certain amounts in the prior years' financial statements have been reclassified to conform to current year presentation. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the period. The most significant estimates reflected in these financial statements include accounts receivable and sales allowances, inventory valuation, acquisition accounting, valuation of intangible assets and goodwill, restructuring and other charges, valuation of deferred tax assets and warranty reserves. Actual results could differ from those estimates.

Cash, Cash Equivalents, Short-term Investments and Restricted Cash

The Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents; all securities purchased with an original maturity of greater than three months and that mature within 12 months from the balance sheet date are considered short-term investments. All investments are classified as available for sale and are carried at fair value, with unrealized gains and losses included in other comprehensive income or loss, which is a separate component of stockholders' equity, until realized. The Company recognizes realized gains and losses on a specific identification basis. The Company invests excess cash primarily in municipal bonds, money market funds and government agency securities.

At September 30, 2002 and 2003, $47,000 of cash was restricted and pledged as collateral on the Company's facilities. Additionally, at September 30, 2002, $1,051,000 was restricted and deposited with a financial institution as a guarantee for a personal loan of the Company's Chairman (see Note 8).

Concentrations of Risk

Credit. Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash, cash equivalents, restricted cash, short-term investments and trade receivables. The Company invests primarily in money market funds of major financial institutions as well as government agency securities. There are no significant concentrations in any one issuer of securities. The Company provides credit to customers in the normal course of business and does not require collateral from its customers, but routinely assesses their financial strength. The Company maintains reserves for potential credit losses and such losses have been within management's expectations.

Customers.

The following table summarizes those customers who accounted for greater than 10% of the Company's net revenues or accounts receivable:

	Net Revenues for the year ended September 30,			Accounts Receivable at September 30,	
	2001	2002	2003	2002	2003
Customer A	*	83%	47%	86%	42%

* indicates the amount is less than 10% of total amount.

Fair Value of Financial Instruments

Financial instruments, including cash, cash equivalents, restricted cash, short-term investments, accounts receivable, notes receivable and accounts payable, are carried in the financial statements at amounts that approximate their fair value as of September 30, 2002 and 2003.

Inventories

Inventories are valued at the lower of cost or market, with cost determined using the first-in, first-out method. The Company regularly reviews inventory quantities on hand and records a reserve for excess and obsolete inventory based primarily on our estimated forecast of product demand and anticipated production requirements in the near future.

Property and Equipment

Property and equipment are recorded at cost and depreciated using the straight-line method over their estimated useful lives. Leasehold improvements are amortized over the shorter of the useful life

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of the improvement or the remaining term of the lease. Property and equipment held under capital leases is stated at the present value of the minimum lease payments at the inception of the lease and is amortized using the straight-line method over the lesser of the life of the related asset or the term of the lease. Upon retirement or sale, the cost of the assets disposed of and the related accumulated depreciation are removed from the accounts and any resulting gain or loss is included in the determination of net income or loss. Repairs and maintenance are charged to expense as incurred.

Intangible Assets and Goodwill

Intangible assets that resulted from the Company's December 2002 acquisition of

TidalWire Inc. consist of customer relationships (see Note 3). These assets are amortized on a straight-line basis over their estimated useful lives of five years.

Goodwill is the amount by which the cost of acquired net assets exceeded the fair value of those net assets on the date of acquisition. In July 2001, the FASB issued FASB No. 142, "Goodwill and Other Intangible Assets." As a result, goodwill is no longer amortized but tested for impairment under a two-step process. Under the first step, an entity's net assets are broken down into reporting units and compared to their fair value. If the carrying amount of a reporting unit exceeds its fair value, the second step of the goodwill impairment test is performed to measure the amount of impairment loss, if any. The second step compares the implied fair value of a reporting unit's goodwill with the carrying amount of that goodwill. If the carrying amount of a reporting unit's goodwill exceeds the implied fair value of that goodwill, an impairment loss is recognized in an amount equal to that excess. The Company conducted a detailed analysis of goodwill as of September 30, 2003, and determined that goodwill had not been impaired. The Company will analyze goodwill as of September 30 in all future fiscal years, unless a future event occurs that indicates goodwill has been impaired prior to September 30. If such an event occurs, the Company will conduct its goodwill impairment analysis at that time (see Note 16).

Impairment of Long-lived Assets

The Company evaluates the recoverability of its long-lived assets which include amortizable intangible assets, in accordance with Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS 144"). SFAS 144 requires recognition of impairment of long-lived assets in the event the net book value of such assets exceeds the future undiscounted cash flows attributable to such assets. If an impairment is indicated, the assets are written down to their estimated fair value.

Revenue Recognition

The Company generally recognizes product revenue upon shipment to customers provided persuasive evidence of the arrangement has been received, the sales price is fixed or determinable, collection of the related receivable is reasonably assured and title and risk of loss have passed to the customer. When the Company enters into revenue arrangements containing multiple elements, such as

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the sale of both the product and post-sales support, we allocate the total revenue to be earned under the arrangement among the various elements based on vendor-specific objective evidence of the fair value of each element. If the Company is not able to derive vendor-specific objective evidence of the fair value of each component, revenues are deferred and recognized ratably over the period of the support arrangement, which is typically one year. For post-sales support services, revenue is recognized ratably over the period the services are performed. Historically, the Company's OEM Appliance customers have not been